#7, 1 March 1999
A Publication of the International Centre for Policy Studies
ICPS newsletter

1999 Will Become a Do-or-Die Year for the Ukrainian Economy

This week will see the next issue of Quarterly Predictions s a member of the International Centre for Policy Studies publications family s coming into circulation. Quarterly Predictions will present a revised prognosis on the development of the Ukrainian economy in 1999. The ICPS economic team downgraded the forecast volumes of main macroeconomic indicators and introduced a two-scenario approach for the first time. The economists suggest that the Ukrainian economy has two ways to go in 1999 s an optimistic scenario and a pessimistic one. The difference between the two lies in the ability or inability of the Ukrainian government to adhere to a reform agenda.

Should Ukraine carry out reforms and receive financial support from International Financial Institutions, real GDP is forecast to fall by 3% in 1999 mainly due to bankruptcies of non-viable enterprises and a sharp decrease in state consumption. Though economic recovery and reduction in state interference will lay the foundations for economic growth in 2000.

If Ukraine fails to fulfil necessary reforms and loses the trust of international lenders, the government is likely to default on its external debt. The hryvnia will depreciate to 6 UAH/USD, and the inflation rate will accelerate to 50% per annum. Under these circumstances real GDP will fall by 5%, investment and real income will considerably dwindle.

Reforms Must Eliminate the Soviet Economic System

The main goal of Ukrainian economic reforms in 1999 is to remove the Soviet-type system that provides support to loss-making enterprises at the expense of (1) effective enterprises that generate real value added and profits, but are forced to pay excessive taxes, and (2) households, that suffer from the huge wage and social payment arrears of loss-making enterprises and the budget. As a result, this system:

- Large budget deficit which makes the domestic financial system extremely unstable, and forces banks to keep interest rates high;
- Provokes corruption;
- Arrests economic growth, as operations reoriented on simply covering costs become more attractive than technological expansion and investment.

The Quarterly Predictions team states that the following key economic reforms are needed to change this destructive system:

1. **Fix tight budget constraints for all enterprises.** These imply: (1) liquidation of the kartoteka system, which transfers the right of paying taxes to the bank that keeps the account of the enterprise; (2) prohibition of tax allowances and (3) clearances between the budgets of all levels; (4) establishment of effective mechanisms that allow sales of an enterprise's shares if it accumulates arrears, in particular, effective bankruptcy mechanism for protection of the creditor.
2. **Reduction in the administrative regulation of the economy.**
3. **Administrative reform**.
4. **Optimization of budget spending and reduction of the budget deficit.**

Economic Growth Can Start in 2000

Economic trends in 1999 will depend on the extent of reforms stated above are implemented. The impact of these reforms would come through both direct and indirect channels:

- De-monopolization of markets and lower cost of regulation will directly make the investment climate more favorable.
- Financial stability and the support of international investors will indirectly boost the economy.

Based on this, developed are two scenarios of the 1999 forecast:

1. **Optimistic.** Under this scenario, the Ukrainian government will implement the measures described above and, as a result, receive support from international investors. This will prevent from the debt default and preserve financial stability. Rapid structural changes and tight budget

Last Week

EBRD: A Comprehensive Reform Can Offset the Crisis. The basic reason that caused the sharp economic depression in the CIS countries in 1998 was the unbalanced economic reform. Institutional changes lagged behind swift liberalisation and mass privatisation. This created grounds for spreading economic crisis.

These findings were presented by two economists of the European Bank for Reconstruction and Development Julian Exeter and Joel Hellman at the weekly economic seminar at the International Centre for Policy Studies on 23 February. The seminar was devoted to the discussion of the EBRD's 1998 Transition Report.

To the EBRD economists', the failure of economic stabilisation in the countries of Central and Eastern Europe proves the instability basis for growth. Chronically huge fiscal deficits in across the CIS reflects deep structural problems: soft budget constraints for enterprises, non-transparent taxation and inefficient tax collection. Under such conditions the taxation base remains narrow, tax burden on enterprises which pay taxes becomes unbearable and tax evasion is a common thing. Unlike the CIS countries, most of Central European countries demonstrate growth in exports and investments which reflects increased competitiveness of the economies achieved through deep restructuring of enterprises.

Besides, as it is mentioned in the Transition Report, inefficient market mechanisms and non-transparent privatisation lead to the emergence of powerful clan interests. Thus those who benefited on the first stage of the transition to market economy may well block the reforms on the next stage. So, transparent and equal government policies are a key to further development of market oriented transformation.

The EBRD economists consider that the main tasks of economic reforms in economies in transition must be: fulfilment of a strict budget policy and acceleration of structural changes; transparent sale of large enterprises to strategic investors; and elimination of soft budget constraints.

Budget Policy in 1999: What Hinders Economic Growth? This subject was discussed at the quarterly seminar held at the ICPS on 27 February. The seminar was organised under the Centres of Policy Excellence: Budget Policy project financed by the USAID. The objective of the seminar was to review the 1999 budget in an attempt to identify the important fiscal issues facing Ukraine.

The participants discussed the following questions:

- What objectives should be addressed in the formulation of the budget? How are these objectives addressed by the 1999 Budget?
- What criteria should be used to evaluate the Budget and alternative policy options?
- What are alternative approaches to addressing Ukraine's fiscal problems?
- What are the advantages and disadvantages of these alternatives?
- What alternatives should be chosen?
- Are there any barriers to decision-makers accepting recommendation?

This Week

Ukraine Enters the Euro-Atlantic Security System. The International Centre for Policy Studies, the French Institute of International Relations and RAND organisation in co-operation with the Institute of Security Studies of the West European Union and the Renaissance Foundation organised an international conference in Paris on 1-2 March, the subject-matter of the conference being *Ukraine, Great Europe and the Euro-Atlantic Security: Problems of the XXI century*. The following matters were discussed at the conference: Future of the Security System; The European Union and the European Integration; The Washington Summit and Prospects: NATO Enlargement; Development of a European Security and Defence System; and Prospects of Regional Security Arrangements and Ukraine.

How Do State Subsidies Affect the Stability of the National Currency? The coming macroeconomic seminar to be held at the International Centre for Policy Studies on 2 March will host the discussion of the issue running as Effectiveness of State Support to Enterprises and Stability of the Hryvnia. The speaker will be Dr. Ulrich Thissen, German Advisory Group.

policy will reduce real GDP in 1999 by 3%, but bring Ukraine to economic growth in 2000.

2. Pessimistic. Under this scenario, the government fails to change the status quo and to implement reforms. Institutional reforms are extremely important, as failure to implement them will discontinue lending from the IMF and the World Bank. The absence of external financing will lead to the default on governmental payments for foreign debt (by September 1, 1998 international reserves of Ukraine amounted to $685 million, while payments on foreign debt due in 1999 account for $1.9 billion). In the middle of 1999 Ukraine will run out of international reserves and discontinue its foreign debt payments. Tax arrears and clearances will grow rapidly as a share of budget revenue, leading to default on domestic debt and the accumulation of social arrears. Trying to restrain growing disturbances in the country on the eve of presidential elections, the government will breach financial stability, covering budget expenditures through monetary emission. As a result, the hryvnia will drop to 6UAH/USD by the end of 1999, inflation will shoot up to 50%, and investment will fall sharply. Unfavorable business conditions, accompanied by negative expectations for the future, will make entrepreneurs curtail their activities leading to a 5% fall of real GDP in 1999. The loss of production and labor capacity will mean a continued deterioration in 2000.

Real GDP, annual % change

	1998 (estimate)	1999 (optimistic)	1999 (pessimistic)
Real GDP	-1,7	-3,0	-5,0
Real consumption	-2,6	-7,3	-3,8
Real investment	-1,7	-9,8	-14,5
GDP structure, %			
GDP	100	100	100
Consumption	82,4	82,0	83,4
Private consumption	62,7	63,5	62,4
Public consumption	19,7	18,5	21,0
Investment	20	18,6	18,0
Private investment	19,0	18,0	17,0
Public investment	1,0	0,6	1,0
Net export	-2,4	-0,6	-1,4

Source: Derzhkomstat, NBU, estimates and forecasts by Quarterly Predictions team

Economist Wanted

The International Centre for Policy Studies announces a contest for position of research analyst within its Quarterly Predictions project.

Requirements to applicants:

- *degree in economics (including 1999 graduates);*
- *desire to make a career in economic research;*
- *fluency in English and Ukrainian;*
- *strong statistical analysis skills.*

The preference will be given to applicants who consider monetary economics their interest.

The set of application documents must include:

- *the resume;*
- *the best research work in economics to date;*
- *a brief description of current monetary policy issues in Ukraine (one page long in Ukrainian).*

The documents must be sent to the ICPS by e-mail to silchuk@icps.kiev.ua or by conventional mail marked "for Serhiy Ilchuk" until 9 March.

ICPS Newsletter is a weekly publication of the International Centre for Policy Studies delivered by electronic mail.
To be included into the distribution list mail to: marketing@icps.kiev.ua.
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The International Centre for Policy Studies is an independent non-profit research organisation with the objective of improving the development process of Ukrainian policy. This is achieved by increasing the know-how of key government officials for policy choices, formulation, and debate, and the awareness of the public-at-large of the benefits of policy.
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